

CHAPTER 6: THE RELATIONSHIP BETWEEN EVA AND DIVISIONAL PERFORMANCE MEASUREMENT

EVA is innovative in three important ways. First, EVA is not bound by generally accepted accounting principles (GAAP); its users can make whatever adjustments are needed to produce economically valid numbers. Secondly, the usage of EVA at all levels of the organization, on the assumption that all employees, not only senior managers, must undertake their tasks with the overriding goal of creating shareholder value. Finally, EVA offers a means of measuring and communicating performance that can be used in the capital markets, for capital investment appraisal, and in the evaluation and compensation of managerial performance. EVA thus affords management with a common performance measurement language that can be used for all aspects of financial management.

Where previously a company may have used earnings per share for the capital markets, net present value or internal rate of return for capital budgeting, and a target return on net assets for managers, it can now use EVA for all three.

This argument becomes more obvious – that MVA is really just the NPV of the firm. To illustrate the point, consider a typical capital investment. The investment is undertaken when the NPV is positive, and rejected when the NPV is negative. NPV is calculated by subtracting the capital to be invested from the present value of the net cash flows, or

$$\text{NPV}_{\text{project}} = \text{Present Value}_{\text{project}} \text{ minus } \text{Capital}_{\text{project}}$$

Now, consider the formula for MVA:

$$\text{MVA} = \text{Market Value} \text{ minus } \text{Invested Capital}$$

In effect, MVA is equivalent to the present value of the cash flows to all capital providers (i.e the value of the firm), net of the capital invested in the firm. In other words, MVA and

NPV are completely equivalent. The MVA, whether for the entire firm or just a single capital investment project, equals the present value of future EVAs. When viewed this way, firms can use EVA/MVA to evaluate capital investment proposals without fear of contradicting discounted cash flow techniques. One important virtue of using EVA is that the same terminology that is used to communicate externally with shareholders and securities analysts can also be used internally for managerial decision making. For capital budgeting proposals, nothing is lost by using EVA instead of discounted cash flow approaches, because EVA produces the same results.

The advantage of using EVA to evaluate and compensate managerial performance, in place of more conventional accounting measures, is that it is potentially more effective in helping companies to resolve the principal dilemma of corporate governance, the agency problem. Paying managers on the basis of EVA increases the likelihood that they will start to think and act like owners, because their own wealth becomes inextricably linked with that of the shareholders. The shareholders' agenda becomes their own agenda.

In addition to the obvious aim of aligning managers and shareholder interests, EVA incentive plans also seek to limit the risk of losing good managers. For this purpose, and also to compel managers to seek ever higher levels of EVA, a "bonus bank" is established which defers a portion of a manager's EVA-linked compensation to future years. This portion is usually forfeited if the manager leaves the firm voluntarily. Annual bonuses are banked forward rather than paid in full in the first year. Managers can cash in the bonus only if they continue to increase EVA and, of course, stay with the firm. In other words, the bankable part of the EVA-linked bonus is not vested. By inducing good managers to stay, the bonus bank may offer the further advantage of extending managers' horizons for decision-making purposes. Therefore, EVA bonuses are both a short-term and a medium-term incentive. Stock options still play an important role in this scheme by providing long-term incentives for value creation.

ECONOMIC VALUE ADDED

Of course, EVA is not a panacea and should never be viewed as a substitute for good management practice. What EVA can do is put the proper incentives and monitoring systems in place to increase the chances that managers will run the firm in a manner consistent with the creation of shareholders value.